COMMON GROUND

FOR THE CANADIAN COMMON MARKET

F.R. Flatters and R.G. Lipsey

This study utilizes international trade theory to examine the economic case for the Canadian common market, that is, for institutions ensuring the free movement of goods, services, people, and capital among Canadian regions.

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FOREWORD

Of the many public policy issues involving economics, politics, and governmental institutions, perhaps none is more controversial than that involving size. Are larger units, be they common markets, industrial plants, or bureaucracies, necessarily better than smaller ones? Is efficiency the only criterion by which to judge a question of size? How much weight should be put on socio-cultural factors in making an assessment of the merits of bigness versus smallness?

In this essay, another in the Institute's Essays in International Economics series, Professors Flatters and Lipsey attempt to answer some of these questions in terms of the optimal size of the Canadian market. They situate their argument in the context of the ongoing discussion of the Canadian Constitution and review with great clarity the analytic framework of neo-classical economics. In so doing, they demonstrate clearly the common tradition of both international and regional economics. The essay will thus be of use to all those who specialize in these two areas as well as to those who have an interest in the economics of federal states or of regional economic issues.

The Institute is grateful to the Business Council on National Issues and in particular to Dr. James Fleck, a member of both organizations, for making this material available for wider dissemination.

Gordon Robertson
President
June 1983

AVANT-PROPOS

C'est peut-être le problème de la taille, parmi toutes les questions qui touchent l'économie, la politique et les organes de l'État, qui suscite le plus de controverse. Les grandes entités, qu'il s'agisse de marchés communs, d'installations industrielles ou de bureaucracies, sont-elles nécessairement meilleures que les petites? L'efficacité est-elle le seul facteur qui entre en jeu? Quel poids accorder aux facteurs socio-culturels dans l'évaluation des mérites respectifs du gros et du petit?

Dans cet essai, partie de la série sur l'économie internationale de l'Institut, les professeurs Flatters et Lipsey tentent de répondre à quelques-unes de ces questions à la lumière de la taille optimale du marché canadien. Ils situent leur argumentation dans le contexte du débat permanent sur la constitution canadienne et font un portrait précis du cadre analytique de l'économie néo-classique. Ce faisant, ils font ressortir clairement la communauté des traditions de l'économie internationale et de l'économie régionale. Cet essai servira donc à tous les spécialistes de ces domaines ainsi qu'à tout lecteur qui s'intéresse à l'économie des États fédéraux ou aux questions économiques régionales.

L'Institut est redevable au Conseil d'entreprise pour les questions d'intérêt national et en particulier à M. James Fleck, membre des deux organismes, pour la possibilité de diffuser cette documentation.

Gordon Robertson
Président
Juin 1983

THE AUTHORS

Frank R. Flatters was born in 1944 and studied at Carleton University (B.A.), the University of Western Ontario (M.A.), and the Johns Hopkins University (Ph.D., economics). Professor Flatters has taught at Johns Hopkins, the University of Chicago, and Queen's University and is presently an associate professor and chairman of graduate studies in economics at Queen's. He has written extensively on trade policy, social policy, and regional fiscal policy.

Richard G. Lipsey was born in 1928 and was educated at the University of British Columbia (B.A.), the University of Toronto (M.A.), and the London School of Economics (Ph.D.). He joined the staff of the LSE as an assistant lecturer in 1953 and was appointed to an LSE chair in economics in 1961. In 1963 he moved to the new University of Essex where he became chairman of the Department of Economics and Dean of the Faculty of Social Science. During the 1960s he held many public appointments in the United Kingdom.

In 1970 Professor Lipsey returned to Canada and since then has been Sir Edward Peacock Professor of Economics at Queen's University. He has held visiting appointments at the University of California at Berkeley, the University of Wisconsin, the University of British Columbia, the University of Colorado at Boulder, Manchester University, City University at London, England, and at Yale University

where he was the Irving Fisher Visiting Professor during 1979-80. He is a fellow of the Econometric Society and the Royal Society of Canada and a past president of the Canadian Economics Association.

Professor Lipsey is the author of several text books which among them have been translated into twelve languages. He has numerous contributions on topics in theoretical and applied economics and economic policy, covering most branches of micro and macro economics and published in journals in Canada, the United States and the United Kingdon.

EXECUTIVE SUMMARY

One of the key questions with respect to the functioning of any economic system with distinct component parts is the presence or absence of barriers between them. Some such barriers are natural—the accident of geography is one—and cannot be influenced by public policy. Others are directly under the control of the various political units that make up the economic system and therefore are the subject matter of public policy. It is the role of these barriers, generally direct, but occasionally indirect, that forms the basis of this essay on the state of the Canadian economic union.

Professors Flatters and Lipsey first define their concepts and terms, stressing the importance of economic efficiency. They review the law and institutional arrangements of other federal states and of two contemporary supranational bodies, the EEC and the GATT. They then examine the Canadian situation in some detail and find that under present constitutional arrangements, there are far fewer legal safeguards against the undermining of the domestic market than there are in many other federations or in the two supranational bodies referred to above. They also argue that federal or provincial government de facto political behaviour provides little protection for the maintenance of a common market. Reviewing Canadian economic history from the 1930s onward, they conclude that a large number of important divergences from the common market principle are immediately apparent, that the number of such divergences is much greater than is obvious from any existing catalogue of them, and that

the amount of regional and provincial protectionism is not likely to diminish in the economic circumstances of the 1980s.

An economic case for a common market, using the classical gains-from-trade argument, is then developed by the authors, as is the important "second best" caveat whereby under some circumstances any one additional interprovincial restriction might conversely increase, rather than lower, total Canadian output. In addition, the authors point out that regional unemployment, regional development policies, and resource rents—all important on the Canadian scene—might well justify regionally discriminatory policies and hence qualify the strong economic case for a common market without restrictions.

Sensing, however, what they regard as the inevitable slow drift to even greater barriers to interprovincial trade, the authors conclude by proposing a constitutionally enshrined set of institutions and principles that would go beyond the few changes found in the Constitution Act, 1982. The right to free movement of goods, labour, and capital would be guaranteed, they suggest, although this right could be abridged in the interest of aiding the development of a specific region with low per capita income and high unemployment.

ABRÉGÉ

Il est de toute première importance, lorsqu'on traite du fonctionnement de tout régime économique composé d'entités distinctes, de déceler la présence ou non de barrières entre elles. Certaines barrières – dont la géographie – sont naturelles et ne donnent pas prise aux politiques. D'autres, par contre, relèvent directement des divers organes politiques qui composent le régime économique : elles ont donc des rapports avec la politique générale. C'est le rôle de ces barrières, habituellement directes mais parfois indirectes, qui constitue le sujet de cet essai sur l'état de l'union économique canadienne.

Les professeurs Flatters et Lipsey définissent tout d'abord leurs concepts et leurs termes en insistant sur l'importance de l'efficience économique. Ils passent en revue la loi et les dispositions institutionnelles d'autres États fédéraux et de deux organisations supranationales contemporaines, la CEE et le GATT. Suite à un examen détaillé de la situation canadienne, ils concluent que le Canada est bien moins protégé contre l'érosion de son marché intérieur que de nombreuses fédérations ou que les deux organisations susmentionnées. Les auteurs soutiennent que, de fait, le comportement politique des gouvernements fédéral ou provinciaux ne favorise guère le maintien d'un marché commun. Après avoir donné un aperçu de l'histoire économique depuis 1930, ils concluent à l'existence évidente d'un grand nombre de dérogations au principe du marché commun, nombre beaucoup plus élevé qu'il n'apparaît à l'étude des listes qu'on en a dressées, et que la portée du protectionnisme régional et provincial ne

risque pas de diminuer dans le climat économique des années 1980.

Les auteurs se prononcent ensuite d'un point de vue économique en faveur d'un marché commun et s'appuyent sur l'argument classique des retombées commerciales; ils admettent cependant qu'il puisse arriver que des restrictions interprovinciales fassent augmenter plutôt que diminuer la production globale du Canada. Ils ajoutent que le chômage régional, les orientations de développement régionales et les rendements des ressources – qui jouent un grand rôle sur la scène canadienne – pourraient bien justifier l'adoption de mesures de discrimination régionale et de ce fait obliger à nuancer l'argument de poids en faveur d'un marché commun sans restrictions.

Conscients, cependant, de ce qu'ils considèrent comme une lente et inévitable mise en place d'entraves au commerce interprovincial, les auteurs proposent en conclusion un ensemble d'institutions et de principes constitutionnels dont la portée serait plus étendue que celle des quelques changements qu'a apportés la Loi constitutionnelle de 1982. Ils suggèrent de garantir le droit à la libre circulation des produits ainsi que des travailleurs et du capital, tout en laissant place à des exceptions en vue d'aider au développement de régions où les revenus sont moindres et le chômage élevé.

Chapter I
INTRODUCTION: CONCEPTS AND DEFINITIONS

A major part of the debate on constitutional reform has been the controversy over the need for measures to enshrine and protect the "Canadian common market." Many important issues are involved. Is the Canadian economy in serious danger of becoming "Balkanized"? If so, does this have important implications for our standard of living? What would be the implications for the continuation of Canada as a social and political unit? What are the particular needs and constraints of Canada's federal system of government in the common market context? Questions like these are deep and they are controversial; they are deserving of far more discussion and analysis than they have so far received.

In this essay we wish to make some small contribution to this discussion by examining the economic case for the Canadian common market, that is, for institutions ensuring the free movement of goods, services, people, and capital among Canadian regions. We begin by briefly clarifying the bounds of our discussion.

Economics is concerned, among other things, with the overall level and distribution of material welfare, the so-called standard of living. The standard of living of some sub-group of the Canadian population, such as all skilled workers, or of some region of the whole country, such as the Maritimes, depends on the size of the total national income—Canadian GNP—and that group or region's proportionate share of the GNP.

Economic efficiency is concerned with the size of the total

potential GNP—how to ensure the maximum possible value of the nation's output given the technology and productive resources available. This maximum possible value is called the potential GNP. Inefficient arrangements are those that cause the total GNP available to the whole population to be less than potential GNP, while efficient arrangements are those that permit this potential to be achieved. Distributive justice concerns the relative shares of GNP accruing to the various groups and regions that make up the whole society. In this essay we deal mainly with economic efficiency, with things that will raise total GNP and, hence, average living standards. This is because the economic case for the Canadian common market rests mainly on the efficiency of such an arrangement. Distributive equity takes us beyond economics to philosophical ideas of justice, but it cannot be divorced from efficiency considerations because there is often a conflict between the two: measures that redistribute GNP in conformity with our ideas of justice may affect economic incentives in such a way as to reduce the total GNP so that, on average, there is less available for everyone. Regardless, however, of one's standards of distributive justice, it is normally preferable, other things being equal, to have a larger rather than a small total product to share among the population.

In the absence of any economic integration between a set of regions, there will be barriers in the form of quotas, taxes, tariffs, and other regulations to flows of goods, services, labour, and capital among them. The most elementary form of integration, known as a free trade area, permits goods to be traded among the member regions free of any tariffs, taxes, or quotas that discriminate on the basis of the place of origin of the goods within the free trade area. The members, however, retain their power to adopt different and independent tax-tariff policies on trade with countries or regions outside of the free trade area. The major difference between a free trade area and a customs union is that in the latter, the member regions agree upon common external tariffs to apply to trade with non-member countries. A free trade area thus needs customs points on intra-area boundaries to prevent all imports into the area coming via the member with the lowest external tariff. A customs union requires no intra-area customs points since all imports into the area pay the common tariff. Neither a free trade area nor a

customs union, however, includes provisions for the unimpeded flow of labour and capital among member regions. By contrast, a common market requires that all goods, capital, and labour move freely among regions unhindered by any regulations that discriminate on the basis of region of origin within the common market. In moving from a free trade area to a common market, therefore, governments relinquish control over an increasing number of policy instruments. This diminution of discretionary authority, it should be emphasized, applies to all levels of government within the integrated regions; it is not only the "lower level" governments that relinquish these powers.

Economic integration is seldom seen in any of these pure forms. For some purposes, ranging from economic to socio-political, governments within common markets will engage in economic policies of a regionally discriminatory nature, whether applied to goods, services, capital, or labour. An obvious case is regional development or adjustment policies. The governments of most of the world's integrated economies recognize a need for such policies, and exceptions to non-discriminatory policy rules are provided for these purposes. Generally, however, they also recognize the need to delimit both the nature and the extent of permissible, regionally discriminatory policies and the governmental units to be responsible for such policies. In addition to such regional development policies, as we shall see below, there is a case in a federal state such as Canada for some form of revenue transfer program to reduce differences between the abilities of high- and low-income provinces to raise revenues for government services. The case for a common market is thus not so simple as some might wish to make it appear; it is always necessary to ask how much divergence from the complete common market ideal is desirable.

Among the many different forms of economic integration that are possible, it seems to be taken for granted from observation of other federations and from conventional wisdom regarding our own federal state that the ideal form of integration for Canada is close to a common market. In the context of discussions of constitutional reform, however, it is necessary to re-examine such presumptions. In the next section we describe current concerns regarding the fragility of the Canadian common market. We focus in particular on the nature and

effectiveness of existing guarantees of Canadian economic integration and on practices that indicate divergences from a common market. In the subsequent two sections, we discuss the economic case for the Canadian common market. In the fifth section we examine possible new methods of preserving it.

Chapter II
THE CURRENT CONCERN FOR THE CANADIAN COMMON MARKET

Comparisons With Other Federations and International Organizations

In Australia the Constitution provides a clear statement of the goal of establishing and preserving a common market. Section 92 of the Constitution provides that:

> Intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free.

This provision has been interpreted and enforced in a very broad manner; it applies to all levels of government, to all forms of restrictions on trade (not just tariffs), and to services, labour, and capital as well as to goods.[1] In addition, the federal government (the "Commonwealth") is explicitly prevented from engaging in discriminatory activities by section 99:

> The Commonwealth shall not, by any law or regulation of trade, commerce, or revenue, give preference to one State or any part thereof over another State or any part thereof.

Other sections put further restrictions on regionally discriminatory policies by any level of government. In addition, the Constitution severely restricts the power of state governments to employ regionally discriminatory policies by giving control of many of the instruments for regional discrimination to the federal government (e.g., import duties, control of interstate commerce, competition, securities regulations, etc.). Until recently, these constitutional restrictions have limited severely the ability of governments to engage in many forms of regulatory behaviour, whether or not of a regionally discriminatory

nature. Recently (and inconsistently with past behaviour), High Court rulings have been more permissive with respect to federal regulatory policies. It is still the case, however, that few federal, regionally discriminatory policies have been attempted or tested in the courts.[2]

In the United States, the main constitutional guarantee of the common market is generally regarded to be the trade and commerce power of the federal government. Broad court interpretations of this power have had the effect of establishing paramountcy of federal jurisdiction over the regulation of interstate trade and, to some extent, even of intra-state trade. In addition, this has had the effect of limiting some state powers, such as the ability to favour local industries through state regulations and fiscal measures, and to tax out-of-state business of local firms. In addition to the trade and commerce clause, there are two other articles of the U.S. Constitution directly relevant to the nature of the economic union. Section 2 of article IV provides that:

> The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States,

and the 14th Amendment provides that:

> ...No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States....

The main effect of these provisions has been to limit the ability of the states to engage in discriminatory economic behaviour. This, however, has not been an unmixed blessing, for while there are major constitutional restrictions on discriminatory regulatory behaviour by state governments, there are far fewer restrictions on the federal government.[3] Federal governments have engaged in actions that have serious (although not always intentional) regionally discriminatory effects. Thus experience suggests that reliance on strong federal powers is not sufficient to preserve the common market in a federal state.

Many other federations employ elements of both the Australian practice of direct constitutional restrictions on the power of <u>any</u> government to interfere with the common market and the American practice of combining strong powers for the federal government with

limitations on the discriminatory behaviour of state governments. For instance, the Constitution of the Federal Republic of Germany contains several clauses related to the principles of the common market, such as article 11(1), which provides:

> All Germans shall enjoy freedom of movement throughout the federal territory.

In addition, the federal government has exclusive jurisdiction over "the unity of the customs and commercial territory...the freedom of movement...and the exchange of goods... (article 73[5]).

Article 301 of the Indian Constitution serves a purpose similar to the just-quoted German article:

> Subject to other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.

While the Indian courts have given a quite broad interpretation of this article, other sections of the Constitution and legislative practice have permitted significant variances from the principles of a common market. These arise in the form of geographically discriminatory economic regulations at both the federal and state levels of government.

The experience of certain supernational organizations is also relevant to the argument that we shall develop later. The General Agreement on Tariffs and Trade (GATT), a multilateral agreement setting forth the principles of conduct of nations engaging in international trade, provides an elaborate set of guide-lines. Many of these are aimed at eliminating or regulating various forms of discrimination in commodity trade (e.g., tariffs, subsidies, public procurement policies, technical barriers). While the GATT has not been successful in eliminating all such barriers, it has accomplished major reductions. Particularly in recent years of great stress on the international trading system, it undoubtedly has prevented the massive outbreaks of policies restricting trade and factor movements that occurred in similar circumstances prior to the GATT's formation. The GATT's lack of complete success, however, illustrates a point of some importance. One effect of the GATT guide-lines has been to cause countries to engage in much more subtle forms of discrimination (e.g.,

to shift from tariffs to "voluntary export restraints"). There always will exist methods of escaping from specific anti-discrimination regulations; preservation of the spirit of such rules requires co-operation, and the recognition that, on balance, they are to the mutual benefit of all participants. This is true not only of the GATT but also of most other systems of co-operation among economic units.

The European Economic Community (EEC) is much more ambitious than the GATT and represents an attempt to establish a common market among previously sovereign states. Article 3 of the Treaty of Rome provides for, among other things:

> (a) the elimination, as between Member States, of customs duties and of quantitative restrictions in regard to the import and export of goods, as well as of all other measures having equivalent effect.
>
> . . .
>
> (c) the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital.

These and other principles are then implemented through various regulations and agreements. Great progress has been made through these rules, but once again complete success has not been achieved.[4] There is no doubt, however, that movement of goods and factors is freer in Europe today than it has ever been since the formation of national states with strong economic policies, and also far freer than it would have been had the EEC not been formed.

In the cases of both the GATT and the EEC, which are agreements among sovereign states, the difficulties in implementing non-discriminatory arrangements are of a far greater magnitude than in Canada. The many measures that have actually been implemented illustrate both the great importance that has been attached to solving these problems and the difficulty of doing so. It has been argued that the major force behind these institutions has less to do with the economic benefits that might be achieved than with the political gains that can be enjoyed only through greater economic integration. This is especially true in the case of the EEC.

Constitutional and Political Protections for the Canadian Common Market

With this background to provide some perspective, we turn to an examination of institutional arrangements concerning the Canadian common market. By contrast with most of the cases mentioned above, the Canadian Constitution as embodied in the Constitution Act, 1867[5] provides very little insight into the nature of the Canadian common market. There exists no statement of the principles guiding its goals, structure, or evolution. Furthermore, there are few specific rules to protect the common market. Of the more than 140 sections of the act, only one, section 121, pertains to the nature of the Canadian common market; it provides that:

> All Articles of the Growth, Produce, or Manufacture of any one of the Provinces shall, from and after the Union, be admitted free into each of the other Provinces.

The intention of this section was simply to ensure that each of the provinces entering the union would eliminate existing tariffs on trade among them. Yet it has turned out that this is one of the most important constitutional guarantees of the Canadian common market. What is most noteworthy about this section is what it excludes from consideration. First, it applies only to interprovincial trade in goods; interprovincial flows of services, labour, and capital are not covered. Furthermore, it is not even clear from the wording and its interpretation that it applies to goods produced in, and imported from, other countries. Secondly, it seems to apply only to tariff-type trade barriers; it does not apparently preclude the use of the various forms of non-tariff barriers to trade. Finally, because of the original purpose of the section, it is not clear that it restricts the power of the federal government to impose taxes and tariffs on interprovincial flows of goods. The Canadian common market, to the extent that it exists, therefore, does not appear to be based on any explicit statement in the act of common market principles and of rules for adherence to them.

It has been argued that the common market is preserved in Canada by the strong powers delegated to the federal government and the limitations on provincial powers in the act.[6] The act, in section 92, grants a specific list of sixteen legislative powers to the provincial

governments. The federal government, in section 91, is granted all residual powers, that is,

> all Matters not coming within the Classes of Subjects by this Act assigned exclusively to the Legislatures of the Provinces,

as well as the general mandate,

> to make Laws for the Peace, Order, and good Government of Canada.

The act then goes on to enumerate a set of particular matters over which the federal government is to have exclusive legislative authority. Included in this list is "The Regulation of Trade and Commerce." This has been interpreted by the courts as granting exclusive jurisdiction over international and interprovincial trade and has had the effect of putting severe limits on the ability of the provinces to create direct barriers to interprovincial (but not necessarily intra-provincial) trade. However, the granting to the provinces of exclusive powers over "Property and Civil Rights in the Province," and "Generally all Matters of a merely local or private Nature in the Province" has limited the federal regulatory power over trade and commerce and has permitted the provinces to implement various forms of non-tariff barriers to interprovincial trade. In a similar fashion, the granting of exclusive jurisdiction over indirect taxation to the federal government has constrained the ability of the provinces to use tax-type measures to discriminate between goods produced within and outside a particular province. However, experience has demonstrated that careful drafting of provincial legislation is usually sufficient to overcome these constraints.

Neither the Constitution Act, 1867 nor the strong powers granted to the federal government provide a strong de jure defence of the Canadian common market. First, although provincial governments operate under some constraints on their legislative and regulatory behaviour, there usually exist legally accessible policy instruments that are quite close substitutes for any instruments that are ruled out by the act. Secondly, the granting of strong powers to the federal government does not by itself safeguard the common market because federal economic programs can discriminate severely among regions.

The above observations lead us to ask if the nature of the political process in Canada provides de facto protection even when there is no legal-constitutional protection. It has been argued that there are political forces operating on federal and provincial governments that will provide sufficient safeguards for the common market by tending to restrain them from engaging in regionally discriminatory regulatory behaviour.

First, consider what de facto political forces may act on the federal government. The argument has been advanced that since the federal government is responsible to the whole national community, it will have no incentive to engage in those regionally discriminatory policies that are seriously inefficient.[7] While it is inevitable that particular policies will have regionally differentiated effects, compensation can be made through other complementary programs. This, understandably, is an argument that is most often advanced by the federal government, and we do not find it wholly convincing. A federal government can be elected and stay in power for long periods of time without any support from many significant groups in the population. The federal government needs to gain electoral support in only a simple majority of the parliamentary ridings; elections do not require unanimity or even a majority in every region. The federal government may find it politically advantageous, therefore, to engage in regionally discriminatory policies. This is the criticism in the West of Sir John A. Macdonald's "National Policy" of providing tariff protection to eastern manufacturing industries as well as of many subsequent federal economic development policies.

Now consider what de facto restraining political forces may act on the provinces. Because provinces are responsible only to their local constituencies, it is even more difficult to think of political forces restraining them from engaging in regionally discriminatory policies. They have no electoral incentive to take account of the damaging effects of such policies on the residents of other regions. Consequently, the nature of any restraints on provincial behaviour must be somewhat more subtle. Two main possibilities have been suggested.

The first possibility is that provinces might be aware of their industries' rather weak degree of monopoly power in national and

international markets and hence recognize that there is very little to gain from protectionist policies. While there might be some validity to this argument if the provinces were interested only in economic efficiency and if there were no interregional (and international) mobility of labour and capital, neither of these assumptions is true. First, many protectionist policies are meant to benefit local producers and not consumers. For reasons well documented in the literature on the politics and economics of regulation, producers' interests tend to gain much greater representation than do the interests of consumers in government decision making.[8] This might be expected to be more so at the provincial than the federal level due to the smaller degree of diversity in individual provincial economies as compared with the national economy and the consequent greater uniformity of producers' interests in a province than across the whole country. Secondly, a major purpose of local protectionist policies is not only to provide support to existing producers in a province, but also to attract new firms, industries, and workers to the province. Provincial governments act as if they have a vested interest in maintaining, and preferably expanding, the size and rate of growth of economic activity in their particular province, even if this is at the expense of other provinces. Indeed, province building is one of the strongest forces acting to erode the common market principle. It seems eminently reasonable to local voters for a provincial government to bolster the local economy by such measures as tax relief designed to attract industries to the province and to encourage citizens to invest in the province, buy-locally policies, and rules to encourage the hiring of local provincial labour. But all of these measures inhibit the free flow of goods and factors of production throughout the economy. When they are taken by all provinces they tend to be self-cancelling.[9]

The second possible constraint on provincial behaviour that has been suggested arises from the recognition among all provinces of the mutually damaging nature of parochial protectionist growth policies followed independently by all provincial governments. All provinces stand to gain from a voluntary compact whereby they would agree to restrict their use of such policies on the condition that other provinces did likewise. The possibility for establishing and enforcing such

arrangements exists in Canada: the number of provinces is relatively small and there is an even smaller number of dominant actors. The institutional arrangements for a multitude of different federal-provincial conferences and of meetings of provincial ministers and officials provides a framework for continuous consultation on such matters; the opportunity for co-operation clearly exists.

Unfortunately, there are several difficulties with such purely voluntary co-operative agreements. First, the few dominant provinces, while lending stability to the agreements, may also tend to enforce arrangements that generally favour these major actors. The second, and more important, difficulty is related to the classic problem of the prisoner's dilemma: while it is in the mutual interest of all provinces to refrain from protectionist policies, it is also in the apparent interest of any individual to implement its own protectionist policies. Since the main apparent danger from such policies arises from the possible retaliation of other provinces, the potential for gaining from violating any non-discrimination agreement is greater the stronger is the agreement among the other participants. In these circumstances, reliance on purely voluntary agreements provides a rather fragile form of protection for the common market. Some method of permanently delegating the power to enforce such agreements to some higher authority would greatly strengthen their stability. As we have argued already, the federal government is not likely to be an appropriate authority for this purpose. (The Appendix to this essay gives an example of the prisoner's dilemma problem, which illustrates the strong forces that push towards protectionism in the absence of a binding agreement to avoid such measures.)

The somewhat lengthy argument in this section may now be briefly summarized. We have asked what are the protections against erosion of the Canadian common market by regionally discriminatory policies. First, we looked at the legal situation and found far fewer protections in Canada than in many other federations and supranational bodies such as the GATT and the EEC.[10] Secondly, we looked at de facto political behaviour. At the federal level there is an argument that strong federal government power will protect the national common market interest against local pressures for regionally discriminatory

measures. But there are strong counter-arguments that this is not what is likely to happen at the federal level. At the provincial level we also find few de facto safeguards for the common market. Each provincial government is under strong democratic pressure to do what is in the apparent short-run interest of its local constituency. We conclude, therefore, that neither strong legal nor de facto political protections for an integrated common market exist in Canada today. In the absence of such protections, the principle of the common market may be seriously threatened, particularly in times of economic stress.

Disintegration of the Canadian Common Market

The concerns just voiced are strongly supported by the past experience of the development of the national economy.

The Canadian economy is very small by world standards. With a population of less than 25 million, it is one of the few advanced Western economies without free trade access to markets in excess of 100 million people. Not only is the Canadian economy small, but the great diversity of its regions has dictated, on efficiency grounds, a great diversity in regional economic activities. These factors have been a perpetual source of difficulty for national economic policy and have been a major reason for the high costs of protectionist federal policies that have tended to fragment Canada's trade and production patterns into too many sectors, each serving too small markets.

Canada's regional diversity, however, has been and can continue to be a great source of economic strength. The freedom to shift resources in response to changes in external and internal economic pressures has been an important cause of Canada's economic growth. Canada is a nation of immigrants who came in response to expanded economic opportunities and who, on balance, continue to enjoy a large measure of freedom of movement throughout the land in search of higher living standards. This description applies not only to the labour force but also to entrepreneurs and financial and physical capital. As a result, the regions of the Canadian economy have become highly interdependent.[11] With the recent and anticipated increases in domestic oil prices caused by increasing scarcity of these resources in world markets, for example, workers and capital have been able to

move rapidly to the booming province of Alberta in order that the Canadian economy can take maximum advantage of this change in economic pressures. A large portion of today's Albertans were yesterday's Manitobans, Ontarians, and Newfoundlanders. One thing they all share is their ability as Canadians to move relatively freely in response to their own wishes and opportunities. At the same time the boom in Alberta has created resource shifts in other provinces, such as Ontario, to meet the new pattern of demands for goods and services in Alberta (e.g., pipelines).

The dark side of this story of interdependence is that regionally discriminatory economic policies can have serious effects on the size of the Canadian GNP. The regional side effects of national policies such as the tariff, transportation policies and, most recently, national oil policies have always been a major focus of attention in Canadian policy debates. The reason that national policies can have important regional effects lies in the diversity of regional production patterns. Thus a policy that favours one industry and disadvantages another usually favours one area and disadvantages another. Potentially far more important, however, are policies that are explicitly of a regionally discriminatory nature. Such policies may arise at either level of government, federal (e.g., equalization, Regional Development Incentives Act (RDIA) programs, regionally differentiated unemployment insurance benefits) or provincial (e.g., government purchasing policies, tax incentives, marketing boards).

Regionally discriminatory policies and the practice of intergovernmental competition have a long history in Canada. The "bonusing" system whereby provincial and municipal governments bid against each other to induce firms to locate in their jurisdictions was quite well established in the late nineteenth century. The economic crises of the 1930s triggered an explosion of protective policies by provincial and local governments in an attempt to preserve jobs. At such a time of crisis, one might hope that members of a federation would engage in co-operative behaviour against the common enemy of depression. Yet experience shows that this does not usually happen. In the 1930s the disintegrative forces predicted by the prisoner's dilemma model manifested themselves in a magnified form.

The situation that emerged at that time was a cause of considerable concern to the commissioners who prepared the Rowell-Sirois Report.[12] In the Report itself and in separate studies and appendices, the growth of these barriers to interprovincial trade was well documented and their implications discussed. It is worth quoting from the Report at some length because of the relevance of the discussion to the current situation. The commissioners state in Book II:

> A federation usually starts off with good intentions and the most obvious forms of undesirable discrimination are usually prohibited.... While these provisions of the constitution discountenanced barriers to interprovincial trade they did not preclude them altogether and, under the stress of political pressure, various expedients have recently been devised which, in one way or another, afford some degree of provincial protectionism (p. 62).

Then, after documenting the extent of such measures being employed in the 1930s, they conclude:

> The growing demand for provincial protectionism must not be under-rated....
>
> It is beyond dispute that...local protectionism does tend to hamper national economic life and thus to reduce the income of the people of Canada upon which the prosperity of the whole Dominion rests. It is probable that there is no single province so situated as to gain on balance by the existence of local protectionism in Canada. In each case the desired objective is sought with such immediacy that the longer view, taking account of secondary results and ultimate consequences, is excluded from consideration. It is obvious that if one province can invoke these expedients to serve or protect a local interest, other provinces can do likewise; and that if a protective provincial tariff can be imposed for the advantage of a particular interest, other interests in the same province will exact the same advantage by the employment of political pressure. With the expansion of these experiments in provincial self-sufficiency, it would be speedily found that the local market

> obtained at such a cost would be a poor substitute for the lost freedom of trade throughout the Dominion. The damage done by local protectionism takes many forms: among them, the artificial location of industries within the national economy; the wastes of uneconomic competition; the financial burdens involved in supporting uneconomic industries; the uncertainty to business everywhere if markets in other provinces are in danger of being shut off by protectionist devices; the emphasis laid on rivalry and jealousy between the provinces....
>
> The heart of the problem lies in the fact that the simplest requirements of provincial autonomy in legislation for the control of everyday life, and in matters of taxation, involve the use of powers which are capable of abuse, in the sense that they may be used to establish some sort of provincial protection (pp. 63-64).

Fortunately for the development of the Canadian common market, several forces that came into play after the Report of the Rowell-Sirois Commission caused a significant lessening of the disintegrative tendencies observed by the Commission. The more important of these new forces included the demands of the wartime economy; the post-war economic boom; the implementation of unemployment insurance, tax sharing and eventually the equalization program, all of which strengthened the ability of the federation to perform its "insurance" role; and a centralizing of political power towards the federal government. In this case the centralizing of economic powers served to strengthen the Canadian economic union. It did so because, in the climate of the 1930s and 1940s, the main pressures for local protectionism were on provincial and local governments while the federal government had not yet got into new types of regionally discriminatory policies. The degree of fiscal harmonization achieved between federal and provincial governments was one of the great achievements of post-war public finance in Canada.

But the post-war forces that de-emphasized regional protectionism and emphasized national policies seem now to have spent

themselves. The experience of several recessions, the great growth of provincial fiscal influence in the economy, the growing acceptance by both federal and provincial governments of regional (read provincial) economic development as a legitimate policy goal, and recent shifts in relative strengths of different regions of the country have all contributed to a significant increase in regionally discriminatory policies. Recent trends in public policies indicate that we are witnessing an era of "province building" as an important policy goal. Instead of a single "national policy," whose costs have been well documented in many studies, we are now encountering a whole set of "provincial policies." We have gone full circle and are now back at a point similar to that described by the Rowell-Sirois Commission. However, the greatly increased importance of governments in the economy and the greater interdependence of the regions make the potential costs much greater than was imagined by the Rowell-Sirois commissioners who were pessimistic about what they saw in 1940.

Various lists of regionally discriminatory policies that violate the principles of a Canadian common market have been produced elsewhere. Such policies include discriminatory buying practices by provincial governments and Crown corporations either directly through a stated policy of requiring, say, a 10 per cent cost advantage or a certain share of local production of any goods purchased before purchasing from an out-of-province firm, or indirectly through measures such as exclusion of non-local firms from lists of approved suppliers. Labour laws, such as licensing regulations or explicit "local-labour-first" hiring requirements on government-initiated or regulated projects, discriminate against labour from other regions. Competition policies (e.g., regarding take-overs) and investment incentive programs have similarly distorting effects in capital markets. Provincial marketing agencies have strong incentives to engage in discriminatory behaviour to protect local producers.

It is not our task to develop our own catalogue of such violations of the common market principle.[13] Most of those who have attempted to construct such lists conclude that regionally discriminatory policies are pervasive and continuing to grow throughout the Canadian economy. However, any attempt to produce an exhaustive list of such policies is

doomed to failure because of both their number and the indirect and subtle nature of the workings of many of them. It would be very difficult, therefore, to estimate the magnitude of the cumulative effects of all these policies on Canada's GNP. We do wish, however, to make several observations about the measurement of the efficiency cost of these divergences from the common market principle.

First, even in the absence of any growth in the degree of discrimination through provincial policies, the magnitudes of their effects on the national economy must be much greater today than in the immediate post-war period. The scope of government regulatory activities has grown considerably, and provincial spending has grown dramatically from 10 to 25 per cent of GNP. Furthermore, the influence of provincial governments extends well beyond the activities of any one of their departments. The spending of provincial Crown corporations such as B.C. Hydro, Ontario Hydro, and Hydro-Québec, provincial telephone companies, and public transportation agencies is of great importance, due to both the magnitude of their investment expenditures and the growing interest in promoting employment in the high-technology industries.

Secondly, the importance of various non-tax types of provincial regulatory policies is very difficult to measure. For instance, it is difficult to determine how much potential interprovincial migration might be prevented by labour-market policies such as those implemented in the Quebec construction industry in 1978 or by recent Newfoundland provisions requiring oil firms to train and hire local residents in preference to migrants from elsewhere. Neither do we know how much economic activity is affected by regulations such as those in the Ontario Mining Act of 1969 requiring local processing of mining output.

Thirdly, there are some very important divergences from the common market ideal that seldom appear in such lists. A classic example is the proposed development of the Lower Churchill Falls hydro project in Labrador. At current market prices for electricity, there is no doubt that this development would be of great social benefit. However, because the only economically feasible way for this power to be sold outside of Labrador is to transmit it through Quebec,

several factors have combined to prevent or delay this project. First, Quebec and Newfoundland currently are locked in a dispute over a long-term contract signed in the late 1960s for the sale of Upper Churchill Falls electricity to Hydro-Québec. Essentially, Newfoundland believes that unanticipated energy price increases caused by OPEC oil pricing decisions since 1974 have rendered the previous arrangement unjust as regards the returns to Newfoundland from its electricity exports. Secondly, and in large part due to the same reasons, Newfoundland and Quebec have not been able to come to an agreement over terms for the export of electricity from the proposed Lower Churchill development. Until this transmission dispute is resolved, millions of dollars of wasted revenues will rush away to the sea each year along the Lower Churchill River. This example illustrates the importance of interprovincial institutional arrangements in the achievement of an efficient use of the resources with which this country is endowed, and the power that provinces have to interfere with efficient resource use.

In summary, there are strong forces in Canada pushing towards local and provincial protectionism. These forces were highly evident in the 1930s and had at that time accomplished substantial interference with the Canadian common market. Then in the period during and after the Second World War, these forces were greatly weakened for a while. Now they are strengthening once again, and the trend in Canada is for more regional protectionism. The current extent of such protectionism is almost impossible to measure. However, there can be little doubt that first, a large number of important divergences from the common market principle are immediately apparent; secondly, the number of such divergences is much greater than would be apparent from any existing catalogue of them; and thirdly, the amount of regional protectionism is not likely to diminish.

Chapter III
THE ECONOMIC CASE FOR THE COMMON MARKET

Others before us claim to have observed a significant and growing amount of regional protectionism in Canada today, and we have argued that there are no strong de jure legal or de facto political processes to prevent the occurrence of such policies. "Province building" is now a well-established fact of Canadian economic life. This raises the obvious question: Does it matter? Could not an economy as diverse as Canada's prosper even with substantial amounts of regionally discriminatory protectionist policies?

The short answer is that regionally discriminatory policies designed to gain a larger share of the Canadian GNP for a particular province or area by switching demand from imported to domestically produced products usually have the effect of lowering actual GNP below potential GNP. Canadians run the risk to which the countries of the world succumbed in the 1920s and 1930s of squabbling fiercely over shares of a GNP that is shrinking in relation to its potential size, the very measures being used to obtain a larger share for each area being the measures that reduce the total available for everyone.

In what follows, we concentrate mainly on the free flow of trade within the Canadian federation. We have seen, however, that a common market also encompasses the free flow of factors—labour and capital—within its member areas. Realizing the full economic potential of a common market requires both: just as regions need to be free to produce the things they can produce best and export these in return for imports that other regions can produce best, so do people need to be

free to exploit their natural talents and interests by moving to those areas where these are most needed, and so does capital need to be free to move to where it is most productive. If people are prevented from buying goods from the cheapest sources of supply within Canada, if labour or capital is prevented from going to the locations where its contribution to output is greatest, Canadian GNP and Canadians' living standards will be held below their potential levels.

This is the economic case for mobility of factors as well as of goods. It seems to us, however, that the political reasons for free movement of factors are even stronger than the economic reasons: what is a country if it does not include the right of its citizens to move freely, to work and to invest anywhere within it?

Who Gains and Who Loses From Provincial Protectionism?

If one province's law, or the decision of its provincial purchasing body, favours a local firm so that it gets a contract it would not otherwise get, the local producers have clearly benefited. Much pressure for local protectionism comes from just that simple source: local producers gain (in terms of higher price and/or higher sales volume) whenever political intervention allows them to make sales they could not have made on the free market.

But let us look beyond local gains and consider the national interest. If the local firm gets the sale, someone else loses it. Since we are concerned here with interprovincial trade restrictions, and not international ones, the firms that lose the sales in the cases that concern us would be located elsewhere in Canada. Thus, from the national point of view, there is an equivalent loss to set against the gain. What one firm gains, another firm loses; a given amount of economic activity has been redistributed in favour of intra-provincial trade and against interprovincial trade.

When all ten provinces do this, the result is the same, only on a grander scale. If discriminatory laws and purchasing behaviour cause an average of $100 million to be spent on local products rather than on goods from other provinces in each of the ten provinces, then $100 million of sales is lost by other provinces in each case so that when the dust has settled, $1 billion worth of demand will have been switched

from interprovincial to intra-provincial trade.

At first glance, the net effect of all this on the nation as a whole would appear to be zero since for every gainer there is a loser. But this is not so. GNP is reduced below its potential if anything other than the least-cost source of output is used. If the local source were the cheapest source of supply, local protection would not need to be used. Therefore the effect of regional protectionist policies is not to increase total national economic activity, but rather to redistribute it in an inefficient way from lower- to higher-cost sources of supply, thereby reducing national GNP below its potential.

This line of reasoning is merely an application of the law of the gains from trade. Roughly speaking, this principle of economics states that the total output of any set of regions will be higher when each specializes in producing the commodities it can make most cheaply and satisfies its need for other commodities by trade. In the 1920s and 1930s, the countries of the world learned the truth of this doctrine of the gains from trade by the bitter experience of ignoring it. Country after country sought to increase its employment and its living standards by restricting imports and shifting demand to home goods. But in each country where the policy was initially successful, some other country lost exports so that its employment and income fell. This second country then tried the same policy to the detriment of a third and so on. The end result was no more employment, a lower volume of exports and imports, and lower living standards everywhere because each country was making, at high cost, goods it would have imported from its trading partners at lower cost. This is exactly what each province to some degree is doing in Canada today.

Such policies are named "beggar-my-neighbour" policies for the obvious reason that one country seeks to reduce its unemployment and raise its income by measures that raise unemployment and lower income in other countries. A general round of beggar-my-neighbour policies is likely to end up hurting everyone. First, overall employment does not rise. Secondly, living standards are reduced because each country is both producing for itself many products behind trade barriers that could be produced more cheaply abroad, and is also producing for export less of the products it could produce most cheaply itself

(because other countries are producing them behind trade barriers rather than buying them from the cheapest available source).

Ever since Adam Smith and David Ricardo, it has been known that much of today's high living standards is due to the gains from trade. Each country's GNP is higher if it concentrates on producing the things it can produce at least cost, exporting these for imports of other goods, than if it tries to produce a wider range of goods under tariff protection. It has also been clear that, relative to its GNP, the gains from international trade are larger for small countries such as Canada or Australia than for large countries such as the United States or the U.S.S.R. This is for two reasons. First, a small country will not cause the prices of its import goods to rise or of its export goods to fall by entering into international markets (nor is there any scope to force prices up by restricting its trade). Secondly, most industries have a minimum efficient scale below which unit costs rise as output falls. If a small country tries to produce many products under tariff protection, most of its protected industries will be operating well below their minimum efficient scales. Since the cost of producing each commodity will be higher than necessary, the total output will be lower than it would be if fewer goods were produced in larger quantities and the surplus output exported to pay for imports of other goods.

Most estimates of the loss of output caused by tariffs and other market distortions involve numbers that are not a particularly large percentage of GNP.[14] However, since Canada is a small country by international standards, we would expect the effect of the Canadian tariff to be a relatively larger reduction in Canadian GNP below its potential level. While attempts to estimate this cost have been few, two recent studies put the cost of the Canadian tariff at more than 5 per cent of our GNP.[15] Five per cent of potential GNP may not sound like a lot but it amounts to $13 billion per year, which is equal to 50 per cent of total federal government expenditure on goods and services and transfers to persons, three quarters of the size of the entire budget of the Government of Ontario, or enough to increase total investment in Canada by almost 25 per cent. Also, at a real interest rate of, say, 5 per cent, it would require a capital investment of $260 billion to produce that much annual return. Hence, adopting policies that

sacrifice 5 per cent of national income is analogous to destroying $260 billion worth of capital at 1980 market prices.

If Canada is small by international standards, each of its ten provinces is, on average, an order of magnitude smaller. Thus, if each province produced the equivalent interference to interprovincial trade as does the national tariff to international trade, this might reduce Canadian GNP by more than does the national tariff.

A further gain from free international trade is the encouragement it gives to maintain international competitiveness by holding down costs and thus maximizing the total GNP that can be produced. World-wide competitive conditions are constantly changing. New products and new methods of producing old products are constantly being invented. When a domestic industry comes up against stiffened foreign competition as a result of new developments abroad, the effects may go in two different directions. First, the competition may be allowed, in which case the domestic industry will lean to match the foreign competition or it will give way to some other industry that can. Secondly, tariffs or other barriers to trade might be raised to restrict the foreign competition and remove the pressure on the domestic industry to adapt. Restrictive trade barriers provide the easy route for employers and workers in the threatened industry. Yet, if this alternative is chosen frequently, the country ends up with inefficient high-cost industries that find it increasingly difficult to compete abroad and that lower GNP at home by providing goods at higher cost than is necessary. Furthermore, although it is often argued that protection is justified by the high costs of adjustment in the affected industries and labour markets, recent evidence indicates that these adjustment costs are surprisingly low.[16]

Once again, if this argument has force at the level of the Canadian nation competing in international markets, it has much greater force at the level of provincial industries competing in the national market.

"Second Best" Considerations

The proposition that free trade among provinces maximizes the national GNP, and its converse that interferences with interprovincial trade lowers it, follow from comparing the GNP under two conditions: (1)

GNP with national free trade, and (2) GNP with some interprovincial trade restrictions. In this comparison (1) is always larger than (2). Now, however, consider two other situations: (3) the GNP when a certain set of interregional trade barriers apply and (4) the GNP when one more trade restriction is added to the set ruling in (3). Although undermining the simplicity of the argument against trade restrictions, it does not follow that GNP under (4) will always be lower than GNP under (3).

This important result is part of what is called "The General Theory of Second Best."[17] It states that no one can be sure that the imposition of any one existing barrier will worsen the performance of the Canadian economy or lower the living standards of Canadians.[18] The intuitive explanation is that it is always possible that the new barrier will offset some of the harmful effects of another existing barrier. If, for example, one province restricts imports from abroad and subsidizes domestic production of an inefficient textile industry, this will divert its resources from its efficient lines of production to its inefficient textile industry. If a second province places barriers on the importation of textiles from the first, this will reduce the size of the first's inefficient textile industry and reduce the amount of productive resources wastefully allocated to that industry. The second trade restriction policy will have offset some of the harmful effects of the first and actually have increased GNP.

Any set of interprovincial trade restrictions will lead to a total Canadian GNP lower than would result from free interprovincial trade. Any one additional restriction may, however, increase national GNP for the reasons just described. But before we jump to the conclusion that there is a strong case for selective increases in barriers to interprovincial trade, we must look at these barriers collectively rather than individually.

Cumulative Effects

Consider next the effects within Canada of the imposition of a new restriction on interprovincial trade. The immediate gainers are the protected producers (employers and workers) in the province imposing the restriction. The losers are local consumers plus producers in other provinces. It is well known that the political process often makes

governments more sensitive to the interests of producers who are concentrated and clearly visible than to those of consumers who are diffused throughout the province and hence less visible. The pattern of immediate local gains and losses—gains to local producers and losses to local consumers and out-of-province producers—means that the imposition of a new trade restriction is likely to appear as a gain to the province imposing it whether the restriction raises or lowers national GNP (or even local living standards).

To appreciate the effect of the forces set up by this balance between apparent gains to the initiating province and losses to other provinces, we must view trade restrictions not just in a static way, as in viewing a snap shot taken at some point in time, but as a dynamic process, as in viewing a movie. In doing this we notice that the apparent success of trade restrictions in one province can lead to the desire to copy that experience in other provinces. The tendency of trade restrictions to breed further trade restrictions has been demonstrated in practice over and over again. One area gains a temporary advantage over another by restricting imports. But the second area then tries to gain a similar advantage by encouraging local production and local employment thus restricting its imports. When all the dust has settled, everyone's temporary advantage has been dissipated by everyone else's attempts to gain their advantage; trade has been greatly reduced and, on average, everyone is worse off as a result. This is not to suggest that all trade will disappear; at some point the apparent gains to a province from restricting trade will be outweighed by the costs of doing so. However, patterns of trade that emerge will be far from those that would be most efficient. It will be highly unlikely that any province would be better off than under completely free trade.

Developments concerning interprovincial trade in Canada over the past few decades illustrate the same pressures that have been manifested in international markets and that have made it necessary to create institutions such as the GATT and the EEC. As we have seen above, the Canadian provinces have been adding significantly to trade barriers in an effort to shift demand from goods imported from other provinces to goods produced in the home province, and statements of

intent make it clear that the provinces would like to do more in this line. If these developments continue unchecked, the provinces seem destined to learn the hard way the lesson learned decades ago by sovereign countries: beggar-my-neighbour policies at best bring short-term gains to the region adopting them, but in the long term they reduce every region's living standards by reducing the volume of interregional trade.

Interregional factor movements are of greater importance within Canada than among sovereign nations, yet the range of beggar-my-neighbour-type policies has been extended significantly to restrict the regional allocation of investment in financial and physical capital and the migration of labour. The dynamics of such policies are similar to those that apply to interprovincial trade.

The behaviour of the Canadian provinces illustrates what sovereign nations have also learned: local political pressures for short-term gain, particularly in times of economic stress, are very hard to resist on a piecemeal basis. If there is no other line of resistance, the slow drift to ever greater barriers to interprovincial trade and factor movements seems almost inevitable. One effective way to resist this drift is through commitment to a "higher body" that restricts the ability of governments to raise barriers on a piecemeal basis. In the EEC it is the Treaty of Rome; in the GATT it is membership in the organization; in Australia it is the federal Constitution that prevents the piecemeal growth of trade restrictions.

Before concluding, however, that there is an economic case for similar types of institutional arrangements in Canada and inquiring into the nature of such arrangements, it is necessary to examine a little more closely some possible qualifications to the argument. These are based on the high degree of mobility of labour and capital among Canadian provinces. As we already have mentioned, movements of factors of production (labour and capital) are of much greater importance among regions of Canada than among most countries. Such factor movements are certainly affected by economic policies and to some extent, at least, can be a conscious target of policy makers. Does this fact tend in any way to weaken the economic case for the Canadian common market; does it point to exceptions to the general case?

Chapter IV
POSSIBLE QUALIFICATIONS TO THE CASE FOR THE COMMON MARKET

Having set out the economic case for the Canadian common market, we now examine several possible qualifications to the argument. In particular we look at three factors related to the interregional allocation of factors of production that may justify regionally discriminatory policies: regional unemployment problems, regional development policies, and resource rents.

Regional Unemployment Problems

Regional disparities in unemployment[19] are large in Canada; in 1979, to take an example, the highest and lowest rates were 18.4 per cent in Newfoundland and 3.0 per cent in Saskatchewan. These differences are of understandable concern to the provinces with the higher rates. Yet trade barriers to foster jobs at home are unlikely to be an effective policy to deal with the problem. Two important reasons may be mentioned.

First, only the federal government is large enough on its own to influence total demand significantly in Canada (which it does through its monetary and fiscal policies). What an individual province can do through trade restrictions is to try to shift demand towards itself and away from other provinces. As we pointed out earlier, such beggar-my-neighbour policies will only work if other provinces passively allow the resulting shifts of demand to occur. If, however, they take similar action, a round of trade restrictions reduces interprovincial trade with no significant gains in employment for any one province because all the

"buy-at-home" policies are mutually cancelling.

But this is not all. There is a second force operating as well. Even if other provinces are willing to forgo retaliation and let one province shift demand to its home market, unemployment may not be reduced. This is because the unemployment may be the result of strong natural economic forces that will not yield to a simple policy measure such as raising local demand.

How might this come about? Say that province A, despite possible physical and climatic attractions, has a set of natural endowments that will not produce as high an income as the less attractive province B. Such relative inadequacies in economic opportunities in particular regions might arise for many reasons—for example, inadequate resource base, technological backwardness, slow growth in demand for one region's products, rapid natural growth of the labour force, to mention a few.

There are two major ways in which markets can adjust to such differences in regional employment opportunities. First, in a flexible market, if, because of migration costs or desire for local amenities, people choose to live in province A in spite of having lower incomes, real wages and incomes will fall in A for those kinds of workers who are in excess supply. The declining real wages of some kinds of labour will give the province an advantage in some new lines of production. Real wages will continue to fall until everyone who is willing to stay at the lower wages has a job, while those who are not migrate. In the steady state, province A is a low-wage, low-income province, but it has no special unemployment problem, and those who do not value its amenities as much as they value the higher incomes to be earned in province B, or who are subject to lower migration costs, leave.

Now consider the second way in which the market can adjust. This way is much more common today because we do not have fully flexible wages. Such factors as minimum-wage laws, national unions, and nation-wide pay scales for the federal public service put substantial restraints on the interprovincial wage differentials that are possible. In this case, the same forces work but they express themselves in unemployment. People who prefer province A stay in A, but wages do not fall to create new avenues of economic advantage. Instead,

unemployment rates rise until the extra uncertainty of finding a job and the lower life-time income expectations because of bouts of unemployment just balance both the amenities that A enjoys over B and the costs of moving from A to B. In the steady state, those who are willing to stay despite the higher unemployment remain while the others leave. In these circumstances, increasing local demand, even where that is possible, will not lower unemployment: at the same time as new jobs are created, the rate of out-migration slows, so that the rate of unemployment is unchanged. This is because, in the steady state, the rate of unemployment must remain sufficiently high so as to balance the relative amenity and migration cost advantage that province A enjoys over B when wages are the same in both areas. In these circumstances, trade restrictions or labour-market policies such as "employ-local-labour-only" laws or employment subsidies will not reduce unemployment. They will, however, increase employment.

Thus protectionist labour-market policies will cause inefficient use of labour by discouraging workers in high unemployment areas from moving to regions of low employment. Policies to shift demand for goods to the high unemployment areas will restrict the movement of goods. This will reduce total Canadian demand by reducing the size of the tariff-free local market on which much economic activity depends.

The danger to the common market is that, far from reducing unemployment, these labour-market or demand-generating measures applied with ever increasing severity will only reduce the volume of trade and further fragment the national market. Furthermore, even in the absence of cumulative retaliation, the cost of regional employment policies would be far from negligible.[20] As we have already described, the effect of new job creation in high unemployment regions will be to cause a roughly similar reduction in migration to regions of greater economic opportunity. In effect, therefore, new jobs are filled, not by the unemployed but rather by persons who otherwise would have been employed in higher productivity regions of the country.

It seems indisputable that if Canadian provinces had restricted interprovincial labour movements in the past, unemployment disparities would have been much higher than they are now. The major guarantee of the maximum chance of a job for Canadians in a changing

world clearly lies in free movement of labour and goods throughout the country rather than the attempt to preserve local jobs by restricting such movement. Regional unemployment problems do not provide a serious qualification to the case for the Canadian common market.

Regional Development Policies

There is clearly a strong demand in Canada for some geographically discriminating policies in the interests of regional development. We are sceptical of such policies and feel they are likely to inhibit regional development in the end by shoring up declining industries. As Professor L. Thurow recently wrote:[21]

> New England is [now] a prosperous region because it got out of its old dying industries and into new growth industries. If Washington had protected New England's old dying industries, the area would still be depressed. It is correct to point out that New England went through forty years of economic pain before it made that transition, but the correct answer to this is a national policy for aiding individuals and speeding up the transition. To prop up dying industries will only prolong the pain. Whatever government does they will die in the end.

We would thus prefer a situation where the common market principle precludes most regionally discriminatory development policies. Because this seems unlikely, there are several issues that require consideration.

First is the question of the level of government to be responsible. Some might argue that the federal government is the appropriate level of government to handle such policies since only it is in a position to strike a balance between the alleged favourable effects on the province to be aided by discriminatory policy and the unfavourable effects on the rest. The weakness of this argument, however, has been displayed already in the context of our previous discussions. In practice, if the federal government is to engage in regionally discriminatory policies, it will be difficult not to give the provinces some say in this matter as well. Some kind of consultative mechanism would be required.

Secondly, how can the regional development motive be prevented

from being an umbrella under which beggar-my-neighbour policies grow to serious proportions? One policy that might be feasible is to follow the EEC's example by writing the common market principle into the Constitution along with defined exceptions. These exceptions would allow specific, regionally discriminatory policies in the defined circumstances of a region being underdeveloped. Possible vehicles for such policies would include a subsidy to capital and permission for local government agencies and provincially owned utilities to buy locally even at a higher price than was available elsewhere in Canada. The most obvious circumstances in which they would be allowed are a per capita income well below and/or an unemployment rate well above the corresponding national averages.

We repeat our opposition to such regionally discriminatory development policies. We believe that wherever they are allowed, they will in practice do more harm than good for the area receiving "favourable" treatment.[22] But if such policies are to be allowed, it is important to circumscribe them so as to make them genuine special-case policies. Institutions would be needed to prevent the provinces from horse-trading concessions among themselves, each obtaining a restriction with respect to the common market that was popular with their own voters and all acting collectively to erode the common market.

Resource Rents

One of the more important political and economic problems continuing to face Canada today is the distribution of revenues from natural resources. The importance of this for the Canadian common market arises from its possible effects on interregional resource allocation. These effects are at issue for three reasons. First, natural resource exploitation today yields vast rents—returns over and above the cost of exploiting them, including a "normal" return on capital. Secondly, governments have the inclination and the fiscal sophistication to appropriate a large proportion of these rents for themselves. Thirdly, the resources are being exploited in a federal state where there is conflict over which level of government should control what portion of the rents.

Since a provincial government makes use of its revenues, including those from resource rents, for the benefit of its residents and their employers, this makes the right to share in these benefits contingent on residing or investing in the province. For example, a province could use large resource royalties to provide low provincial income taxes and a high level of provincial services. Consequently the interregional allocation of economic activity will be profoundly affected by interprovincial differences in resource revenues. We should emphasize here that it is on the effects of interregional differences in fiscal incentives that we are focusing; we do not intend to discuss the effects of any of these disputes on resource prices since our analysis holds true for any given level of resource prices. This resource allocation problem would not arise, however, in a unitary state since all of the government's fiscal benefits from resource rents would be distributed from a single source. The problem is inherent in a federal system such as Canada's in which provinces have independent power to exploit their tax capacities for the benefit of their citizens.[23]

The radical increases in Canadian oil prices since 1974 have given rise, under current fiscal arrangements, to very large interprovincial differences in fiscal benefits from resource rents. These fiscal incentives set up immensely powerful forces influencing migration and interregional investment choices within Canada. Such forces have never before been felt in our history. Recent federal budget estimates suggest that the difference in fiscal advantages of living in Alberta rather than Ontario are about $4 500 per person per year. For an "average" family (of 3.5 persons), such an incentive would induce migration into Alberta until all other advantages of living there (wages plus all other amenities) were $15 750 less than those of living in Ontario, which has no significant resource rents.

Quite apart from the question of the social desirability of such a situation, it clearly would be a very inefficient use of the nation's resources. Migration and investment decisions would be guided not only by differences in the social advantages of living in different regions, but also by the desire to obtain a share of the "social dividend" arising from resource rents. The private incentives to migrate and invest would not correspond to the socially optimal choices. If, for instance, a

person were indifferent between the amenities available in Alberta and Ontario, and could earn wages of $35 000 in Ontario and $20 000 in Alberta, he would move to Alberta so long as he could receive fiscal benefits (higher levels of social services and/or lower taxes) that were worth at least $15 000 per year (plus the costs of moving) more than in Ontario. And yet such a move would reduce total GNP by $15 000 per year--the difference between his productivity in Ontario ($35 000) and in Alberta ($20 000). The size of the reduction in total GNP caused by inefficient, fiscally induced migration will depend, therefore, on the magnitude of the differences in "social dividends" made possible by provincial government resource rents collected and on the number of people induced to migrate as a result. The same analysis applies also to investment decisions based on government fiscal incentives made possible by resource revenues.

The existence of significant resource rents appropriated by some (but not all) provincial governments will thus cause an inefficient use of the nation's productive capabilities under a regime of free mobility of labour and investment. We would not wish to dispute that large changes in oil prices should bring about a significant reallocation of Canadian economic activity. In fact we would argue strenuously that throughout the 1970s federal policies caused great harm to the Canadian economy by refusing to permit domestic oil prices to rise to world levels. Large and economically efficient adjustments in the supply and use of oil and gas resources were stifled as a result of these short-sighted policies. Furthermore, there will be a significant shift in economic activity towards the west as a result of a proper oil-pricing strategy. Our view, however, is simply that under existing institutional arrangements, the fiscal surplus accruing to the residents of one province as a result of these policies would cause a shift in economic activity far in excess of what would be economically efficient.

The argument so far can be summarized as follows. Natural economic forces would cause shifts in economic activity towards resource-rich provinces even if there were no significant government taxation of resource industries. It would be folly to resist such shifts based on changes in natural economic advantage. The problem comes when there is a very large fiscal dividend that can be "earned" solely by

virtue of residence in one province. This attracts more people than natural advantage can support until their inefficient use (or lack of use through unemployment) removes the incentive for further in-migration.

Efficiency in the regional allocation of the nation's economic activity in the presence of large differences in resource rents accruing to provincial governments requires some combination of the following policies:

1. Reducing governments' share of the resource rents leaving the majority in the hands of private firms
2. Transferring a major share of government resource revenues to the federal government
3. Using some form of interregional fiscal transfers to reduce differences in fiscal advantages from resource rents between provinces
4. Restricting migration in such a way as to counteract inefficient rent-seeking migration
5. Forcing provincial governments to follow common corporate tax and incentive policies so that fiscal advantages due to resource rents cannot be used to lure investment to the province.

The first three of these policies are different ways of ensuring that individual provinces do not appropriate for their own residents or their employers disproportionately large amounts of the rents from resources located within their jurisdiction. The last two are meant to counteract the effects of any such differences in fiscal dividends on resource allocation decisions.

The first policy of leaving the majority of resource rents in the hands of private firms is politically unacceptable in this day and age. There is no compelling economic argument in favour of the second policy. Transferring large amounts of revenue to the federal government is no guarantee against the subsequent use of regionally discriminatory economic policies or for the use of the revenues in ways that would be approved of by the majority of the provinces. Since the resources belong to the provinces, there is a strong argument that the rents from them should be used in ways approved of by the provinces. There is no doubt that the third policy would be economically efficient. Without some form of revenue transfer program, free movement of

labour and capital in the Canadian common market will cause inefficiencies in the regional allocation of economic activity due to provincial differences in fiscal dividends from large economic rents. Some redistribution of these fiscal dividends would reduce the incentives for such inefficient migration. Furthermore, the general principles underlying the current program of equalization grants seem now to be well established and to have gained a considerable degree of political acceptability. There would, of course, be no need to rely on current federal programs to redistribute fiscal surpluses from oil rents among provinces; in fact both the provinces and the federal government appear to agree that the current equalization grants program is in need of revision, particularly with respect to the treatment of provincial resource revenues. The expiry of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, in 1982, is now providing the opportunity to make amendments to the program.

The fourth policy, restricting interprovincial migration, would be a clear violation of the common market principle. It would, however, have some economic justification in the absence of other policies to reduce both resource-rents-induced differences in provincial fiscal positions and the consequent excessive migration into resource-rich provinces. Such migration would be a very inefficient mechanism for sharing publicly collected resource rents across the whole population and could be prevented only by restricting or penalizing such migration. Indeed, if nothing else is done and such "excessive" immigration occurs, oil-rich provinces will be put under pressure to reduce immigration from the rest of Canada in just the same way that the United States was put under pressure to reduce immigration from the rest of the world once the frontier disappeared. The United States gave in to that pressure in the interests of the welfare of its present citizens. Under equivalent pressure, the oil-rich provinces would find it hard to do otherwise.

The fifth policy, prohibiting resource-rich provinces from using their advantageous fiscal positions to subsidize new investment, is perfectly consistent with the principles enunciated earlier for preserving the common market. The possible use of resource rents to influence interprovincial investment decisions simply reinforces our

earlier economic arguments for measures to safeguard the Canadian common market.

What can we conclude from this discussion? Do resource rents give rise to serious qualifications to the economic case for the Canadian common market? As we have seen, large differences in provincial government-collected resource revenues give rise to the possibility of excessive (inefficient) shifts of economic activity into the resource-rich provinces. While this might be construed as an economic argument for interfering in the free operation of the common market, it is really an efficiency argument for policies to reduce such large differences in provincial fiscal positions. In the absence of such policies, the economic argument for preserving free migration of labour in the Canadian common market must be qualified. We doubt that this argument would be considered by many to be sufficient to override the very strong political basis for the principle of freedom of movement throughout the nation. It certainly is not an argument for the sorts of restrictions on interprovincial labour mobility currently observed in Canada.

Chapter V
INSTITUTIONAL ARRANGEMENTS FOR PRESERVING THE COMMON MARKET

There are three levels to which one might look for forces to preserve the Canadian common market: the provinces, the federal government, and the Constitution. We look at each of these in turn.

It has been argued that the provinces can be left to strike reasonable bargains among themselves the terms of which will not interfere too much with the common market. We doubt this. The theory of the prisoner's dilemma and voluminous evidence of history suggest that individual provinces will be unable to resist political pressures to adopt barriers to free interprovincial trade and factor movements even when it is appreciated that general increases in such barriers will hurt everyone. To leave the protection of the common market principle to the good judgement of ten provinces acting individually is to fly in the face of theory and evidence. Recognizing their own joint interests in preventing the general breakdown of the common market principle, the provinces need to tie their hands in some way so that they are prevented from making piecemeal decisions, each of which serves their own short-term self-interest but all of which serve to lower the nation's GNP. This requires some authority above the provincial level.

Some people believe that the natural place to look for such an authority is in the federal government. They argue that the federal level is the right level on which to defend the common market principle since the federal government represents the whole country, not just one segment of it. But the facts of Canadian political life are that the federal government can sometimes appear to represent only a segment

of the country, particularly Ontario and Quebec. Also, the federal government does not have an unblemished record of defending the common market principle even where it could have done so. It has failed to assert itself in areas where it had legislative authority when the provinces have engaged in policies or have established institutions that restricted the freedom of trade. At other times, it has engaged in its own regionally discriminatory policies. When this happens, the provinces are naturally unwilling to accept that the federal government should be the sole decision maker on regionally discriminatory policies that affect them directly.

This suggests that a guarantee of the common market above the level of the provinces but not in the sole form of the federal government is required. The other major institution that might do this job is the Constitution. This is an institution whereby sovereign governments, recognizing the forces operating on them, can tie their hands so that they cannot give in to pressures to take decisions that are politically attractive in the short run but harmful to the national interest in the long run.[24] The Constitution also has the advantage of being neutral with respect to any dispute over the balance of power between the federal and provincial governments.

We believe, therefore, that the right to free movement of goods, labour, and capital should be enshrined in the Constitution. Drafting of an appropriate form of words for constitutional clauses is not our expertise. One form of wording is already there in the Australian Constitution and can provide at least a starting point. The most important clauses are those we quoted above. The first would provide that:

> Intercourse among the provinces...shall be absolutely free,

and would be interpreted as applying to all levels of government, to all forms of trade restrictions, and to services, labour, and capital as well as to goods.[25] Federal and provincial governments could be explicitly prevented from discriminatory activities by a clause such as Australia's section 99:

> Governments shall not, by any law or regulation of trade, commerce, or revenue, give preference to one province or any part thereof over another province or part thereof.

It might be argued that these words are too strong since they might be used to prevent almost all regionally discriminatory policies.[26] The significance of words in the Constitution depends, however, on how the courts interpret them. We suspect that forces in Canada are pulling towards a weakening of the common market principle. We would prefer, therefore, to start with a fairly strong set of words that might then be weakened somewhat by interpretation, rather than to start with rather weaker words that might have little restraining force on strong federal and provincial pressures to erode the common market principle.

Whatever the general form of words used, governments would probably want to allow some exceptions to the common market principle. Although it worries us, we feel that some exceptions applying to lower-income regions will have to be made. Some formula such as the following might be used (although such exceptions are not to be found, for example, in the Australian Constitution).

> Upon the agreement of the provinces and the federal government, the free movement of goods, labour, and capital can, in exceptional circumstances, be abridged in the interest of aiding the development of a specific region with low per capita income and high unemployment.

Low and high should not be defined because of the problems created by provinces lying just on one side or the other of the critical value. The meaning of the "agreement of the provinces" would need careful consideration.

How is it decided when a measure breaches the common market principle? Normal constitutional practices would be that, since the common market principle was written into the Constitution, the courts would decide when the principle was violated. We would not object to this; it is what the U.S. Supreme Court does continually.

Some people worry about involving the Canadian Supreme Court in such issues. Debate would no doubt be technical and turn around issues of economics and business practice. Although such issues are frequently dealt with by the U.S. Supreme Court in antitrust cases, and by the Court of the EEC, some people feel the Canadian courts should not get involved in an analogous set of economic issues concerning what

practices are and are not consistent with a common market principle that was guaranteed in the Constitution.

These considerations might lead to the conclusion that the principle need not be in the Constitution. Instead, the Canadian Parliament could enact legislation guaranteeing the common market principle and setting up a federal-provincial review board or boards to determine, first, when a specific measure violated the principle, and then, if it did violate the principle, to approve the exception or to strike it down. According to this view, everything needed could be established by legislation and would not need constitutional reform.

The answer to this view is that what Parliament does by a majority vote, Parliament can undo by a majority vote. The whole essence of the prisoner's dilemma problem is that strong short-term pressures will always exist to violate the long-term interest in preserving the common market principle. A review board of the sort envisioned, acting at the "pleasure" of the federal and provincial governments, would be too easily abolished the first time short-term pressures built up for new beggar-my-neighbour policies. The best way to guarantee its ability to survive short-term pressures for its abolition is to enshrine the principle for its existence in the Constitution.

Thus a constitutionally enshrined set of institutions and principles similar to those just described, or at least serving the same purpose, seem to us to be the best way to ensure the maintenance of Canada as an integrated economic and political unit. If Canadians do nothing to change present institutions, we fear that the already clear erosion of the common market principle will continue.

Canada has just completed a constitutional exercise (the Constitution Act, 1982). We may ask how the new constitutional provisions in the patriation resolution compare with our proposals. A great deal of the discussion leading up to this resolution centred on the problems of preserving the Canadian economic union. What has actually been accomplished? First, there are no new general provisions concerning the free movement of goods and services between regions of Canada. The only items in this regard are the provisions concerning non-renewable resources and electricity in the amended section 92A, the intent of which is to prevent provinces from using their regulatory

power over resources to discriminate among customers in different provinces. Thus, virtually nothing has been done to reduce the well-documented abuses of the common market principle to which we have referred above.

Secondly, with respect to the free movement of people, there is an entirely new section (section 6) on mobility rights, which is intended to prevent laws that discriminate on the basis of a person's province of residence. However, subsection (4) permits discriminatory actions that have as their object the helping of individuals in a province "if the rate of employment in that province is below the rate of employment in Canada." Thus, in effect, there is a blanket exemption to the anti-discrimination provisions in all provinces with above-average unemployment rates. Such a carte blanche is very far from our proposal that such exemptions be granted cautiously and only on a case-by-case basis.

Thirdly, Part III of the resolution entrenches in the Constitution a system of equalization payments "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." We have indicated that such a program is essential to the economic case for a common market in the Canadian federal system. Unfortunately, the actual proposals made in the November 1981 federal budget to the current equalization program are deficient in several major respects.[27]

Finally, there is nothing new in the patriation resolution to prevent violations of the common market principle with respect to interprovincial flows of investment.

In summary, while the new Canadian Constitution makes some improvements with respect to the protection of the Canadian common market, the net effect of the new provisions will be minor in relation to the magnitude of the forces causing the erosion of the Canadian common market.

CONCLUSION

An often quoted and still appropriate adage suggests that Canada has been built in defiance of political and economic forces. Our survey of the state of the Canadian common market and the divisive forces now acting on it leads us to conclude that sustained effort and far-sighted policy measures will be necessary to prevent Canada from being pulled down by these forces. If we do not want the judgement of history to be that the realities of politics and economics were stronger than the vision of nationhood for a people that were neither American nor European but a distinctive third force of their own, then acts of foresight and statesmanship are needed. The preservation of Canada requires recognition of the pervasiveness of the present divisive forces of apparent provincial and federal self-interest, and the creation of a strong set of institutions that will keep the forces in check in the longer-run self-interest of all Canadians.

APPENDIX
THE PRISONER'S DILEMMA APPLIED TO INTERPROVINCIAL RESTRICTIONS ON TRADE

In the classic prisoner's dilemma problem, each of two people makes independent decisions that take the other's possible decisions into account but both are led to an outcome that is inferior to the one they would reach if they co-operated to make a joint decision. We shall consider an illustration concerning interprovincial trade restrictions. To simplify matters we consider only two provinces, A and B, and two trade policies, interprovincial free trade, and substantial interference in interprovincial trade. The numbers for GNPs used in the illustration are hypothetical but their relative magnitudes conform to what theory and evidence tell us they should be: (1) joint GNPs are maximized by interprovincial free trade; (2) one province can improve its position by restricting trade if the other does not follow; but (3) if one province restricts trade, the other can improve its situation somewhat by retaliating and introducing trade the other can improve its own.[28]

With two policies and two provinces there are four possible policy situations. These are illustrated in the so-called pay-off matrix shown below.

The first combination is that both A and B allow free trade. The upper left-hand box shows that they produce a GNP of 100 each for A and B.

The second combination, shown in the upper right-hand box, is when A adopts trade restrictions while B continues to practice free trade. This allows A to raise its GNP to 110 while B's falls to 70. While A is better off and B is worse off, the sum of their GNPs is less than

under universal free trade (because some of the mutual gains from trade have been sacrificed).

Table 1
THE PAY-OFF MATRIX
HYPOTHETICAL GNPS ASSOCIATED WITH
ALTERNATIVE PROVINCIAL POLICIES

A's Policy / B's Policy	Free Trade	Trade Restrictions
Free Trade	(100,100) 200	(110,70) 180
Trade Restrictions	(70,110) 180	(80,80) 160

(The figures in parentheses give the GNP first for A then for B under each of the four policy combinations. The second figure for each combination gives the total GNP for A and B, making the highest total GNP (200 in this case) of all the various policy combinations.)

The third combination, shown in the bottom left-hand box, merely reverses the roles of the two provinces from the second combination. A now adopts free trade while B restricts trade allowing B to raise its GNP to 110 while A's falls to 70.

In the fourth combination, both parties adopt restrictive trade policies. Because the gains from trade are the lowest of the four combinations, this leads to the lowest total GNP. But comparing this with the third situation we see that A is better off restricting trade once B does. The retaliation restores some of A's losses. Similarly, if we start in the second situation where A has restricted trade while B has not, giving A a GNP of 110 and B a GNP of 70, then B can restore some of its losses by retaliating.

Given these outcomes, we now look at A's rational choice of policy if there is no co-operation with B. A sees that there are two possibilities: either B adopts free trade (row 1) or B does not (row 2).

Looking first at what happens if B adopts free trade, A's GNP is maximized if A adopts trade restrictions (GNP=110) rather than free trade (GNP=100). Looking second at what happens if B adopts trade restrictions, A's GNP is once again maximized if A also adopts trade restrictions (GNP=80) rather than free trade GNP (GNP=70). So this line of reasoning leads A to believe that, whatever B does, A should adopt a policy of trade restriction.

An exactly similar line of reasoning by B leads it to conclude that whatever A does, B should adopt a policy of trade restriction.

Their joint self-interest decisions lead to the non-co-operative solution: they are led to the position where their joint GNP (160) is the lowest of the four possible outcomes. Only if they co-operate and say, "I'll adopt free trade if you will," can they reach the joint maximizing position of the free trade situation where total GNP is 200.

This is analogous to the dilemma of empire building and interprovincial restrictions to trade. If one province plays the restrictive game, it can do better than free trade, but if they all play it, they all do worse. Yet rational calculation of self-interest where there is no co-operation on policy setting leads to behaviour that minimizes joint GNP. Only by co-operating and agreeing not to try to exploit the other's passive behaviour can the provinces agree to stay at the joint-maximizing position of mutual free trade. But political pressures to depart from such an agreement are so strong that some kind of "binding oneself in advance" such as is found in the rules of the GAAT and the EEC or in the Australian Constitution seems to be necessary if such agreement is to be anything more than an ephemeral affirmation of the motherhood principle.

NOTES

1. See, for example, Geoffrey Sawer, "Seventy Five Years of Australian Federalism," Australian Journal of Public Administration 36 (March 1977): 1-11.

2. See John Warhurst, State Governments and Australian Tariff Policy, Research Monograph No. 33 (Canberra: The Australian National University, Centre for Research on Federal Financial Relations, 1980).

3. In actual practice, the broad federal powers over interstate commerce may have turned out to be a major hindrance to complete achievement of the American common market. For example, before the policy reforms of 1978, there was a large difference in oil and gas prices between producing and non-producing states (higher in the former) and offsetting differences in availability due to federal regulation of prices of oil and gas sold in interstate (but not intra-state) transactions.

4. Furthermore, the treatment of "guest workers" from non-member countries in the post-OPEC recession illustrates that reductions in intra-group discrimination are sometimes balanced by increases in discrimination among groups.

5. Pursuant to the Constitution Act, 1982, the British North America

Act, 1867 has been renamed the Constitution Act, 1867.

6. "The Canadian economic union, in fact, has been created more by the allocation to Parliament of certain exclusive powers than by Section 121." Hon. Jean Chrétien, Securing the Canadian Economic Union in the Constitution, discussion paper (Ottawa: Minister of Supply and Services Canada, 1980), p. 20.

7. "...the ability of the federal authority to derogate from common market principles is constrained by the fact that Parliament emanates from a national constituency whose support any federal government must preserve to remain in office. Thus, discrimination...must be approved by a majority of the people's representatives in the House of Commons, and may therefore be deemed to be in the national interest.... There is no comparable limitation upon the ability of provincial legislatures to discriminate on the same basis, since they are accountable only to the electorate of a single province." Chrétien, Securing the Canadian Economic Union..., pp. 24-25.

8. See, for instance, Anthony Downs, An Economic Theory of Democracy (New York: Harper & Row, 1957).

9. For the importance of province building see Judith Maxwell and Caroline Pestieau, "Province-Building versus Country-Building," in Economic Realities of Contemporary Confederation (Montreal: C.D. Howe Institute, 1980), pp. 77-94; and Jeff Evenson and Richard Simeon, "The Roots of Discontent," in Proceedings of the Workshop on the Political Economy of Confederation Kingston, 8-10 November 1978 (Ottawa: Minister of Supply and Services Canada, 1979). That the same forces are present in Australia is documented in Warhurst, State Governments and Australian Tariff Policy, pp. 15-21. See Maxwell and Pestieau, Economic Realities of Contemporary Confederation, for a discussion of a policy statement by the province of Quebec of its comparative advantages with the Canadian common market.

10. We have also indicated that the need for legal measures to preserve economic integration is greater in supernational bodies than in established federal states.

11. Interregional trading patterns have been outlined recently in Ontario Treasury, "Interprovincial Trade Flows, Employment and Tariff in Canada," supplementary Material to the 1977 Budget, while the evolution of interregional migration has been described in E. Kenneth Grant and John Vanderkamp, The Economic Causes and Effects of Migration: Canada 1965-71 (Ottawa: Economic Council of Canada, 1976). Documentation and studies (especially historical) are surprisingly weak in this area.

12. Canada, Royal Commission on Dominion-Provincial Relations, Report (Ottawa: King's Printer, 1940).

13. Examples of such catalogues produced by others can be found in Chrétien, Securing the Canadian Economic Union...; Maxwell and Pestieau, Economic Realities of Contemporary Confederation; A.E. Safarian, Canadian Federalism and Economic Integration (Ottawa: Information Canada, 1974).

14. The classic reference here is Arnold C. Harberger, "Monopoly and Resource Allocation," American Economic Review 44 (May 1954): 77-87.

15. R.J. Wonnacott, Canada's Trade Options (Ottawa: Economic Council of Canada, 1975) and a forthcoming Ontario Economic Council study by Richard Harris.

16. See Glenn P. Jenkins, Graham Glenday, John C. Evans, and Claude Montmarquette, "Trade Adjustment Assistance: The Costs of Adjustment and Policy Proposals," (mimeo), report submitted to the Economic Analysis Branch, Department of Industry, Trade and Commerce, 1978.

17. The chicken-and-egg wars caused by provincial marketing agencies in the 1960s and 1970s, restrictive provincial labour laws, and Quebec's use of its monopoly power over the transmission of Churchill Falls hydro-electric power are examples of this.

18. By the same token we cannot predict a priori that the removal of a single tariff barrier will increase economic efficiency.

19. The GATT and the EEC, which we have referred to earlier, have done essentially the same thing, for the same reasons.

20. For a more complete and formal analysis of this issue see Robin Boadway and Frank Flatters, "The Efficiency Basis for Regional Employment Policy," Canadian Journal of Economics 14 (February 1981): 58-77.

21. "The Productivity Problem," in Policies for Stagflation: Focus on Supply, Special Research Report (Toronto: Ontario Economic Council, 1981), pp. 11-54.

22. For one thing, such discriminatory policies often prop up old, uneconomic industries and prevent a painful but, in the end, healthy transition to new industries.

23. The classic reference here is R.G. Lipsey and Kelvin Lancaster, "The General Theory of Second Best," Review of Economic Studies 24 (1956-57): 11-32.

24. Some of the arguments that follow here have been developed more fully in Douglas D. Purvis and Frank F. Flatters, "Ontario: Policies and Problems of Adjustment in the Eighties," in Ontario Economic Council, Developments Abroad and the Domestic Economy (Toronto: The Council, 1980), pp. 129-71 (including discussion); and R.W. Boadway and F. Flatters, Equalization in a Federal State: An Economic Analysis, study prepared for the

Economic Council of Canada (Ottawa: Minister of Supply and Services Canada, 1982).

25. The phrase "absolutely free" seems to have created much difficulty in Australia because of its ambiguity. See Colin Howard, "Constitutional Amendment: Lessons from Past Experience," Australian Quarterly 45 (March 1973): 35-51.

26. Although they have not prevented all regionally discriminatory policies instituted by individual Australian states in the interest of "province building" in that country, see Warhurst, State Government and Australian Tariff Policy.

27. See Robin Boadway and Frank R. Flatters, "The Federal Budget and Equalization," (mimeo), (Kingston: Queen's University, 1982).

28. The argument in the text assumes that provinces can affect the prices at which they buy from and sell to other provinces by trade restrictions. In so far as prices of traded goods are fixed at world markets, trade restriction brings no gain to the restricting province. We feel, however, that there is no clear dichotomy between traded and non-traded goods but a continuum of goods with larger and larger markets depending on the relation of transport costs to production costs. For goods where the market reaches only over a thousand miles or so, one province will be a significant part of the relevant market and will thus be able to influence "foreign" prices by trade restrictions.

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